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Bailout Includes Key Tax Breaks

By TOM HERMAN

Many Americans facing higher taxes this year just got a reprieve.

Several popular tax breaks that expired at the end of last year sprang back to life as part of the historic bailout package signed into law by President Bush on Friday. The thick new law will also protect more than 20 million Americans from getting caught in the tangled web of the alternative minimum tax when they file for 2008.

Among the provisions that got a new lease on life are deductions for state and local sales taxes, for higher-education tuition and for the cost of classroom supplies paid for by millions of schoolteachers. The bill also extended a provision allowing many older taxpayers to make tax-free distributions to charities directly from their individual retirement accounts. This provision has helped charities attract large amounts of donations in recent years.

Even if this weren't an election year, Congress would have faced intense pressure to take action because of growing concern about the health of the economy and financial markets. "Congress was compelled to do this because failing to act would have meant a significant tax increase on middle- and upper-middle-income Americans," says Clint Stretch, managing principal of tax policy at Deloitte in Washington.

Lawmakers also carved out a few new breaks, including provisions designed to benefit victims of natural disasters that hit numerous states from late May through July. Additionally, the measure prolongs the lives of benefits that had been scheduled to expire at the end of this year. Among them is one allowing taxpayers who don't itemize their deductions to claim an additional standard deduction for real-estate taxes of as much as \$1,000 for joint filers, or \$500 for most singles.

Here is a summary of the major provisions affecting individuals, how they work and ideas from tax advisers on how to make maximum use of them.

Alternative minimum tax. The new law includes increases in the AMT income-exemption amounts for 2008. Under the new law, the AMT income-exemption

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amounts for this year will be \$69,950 for joint filers and \$46,200 for individuals, according to a Senate Finance Committee summary. The amounts for 2007 were \$66,250 for joint filers and \$44,350 for individuals. If Congress hadn't changed the law, the amounts would have fallen to only \$45,000 for joint filers and \$33,750 for individuals. The new law also allows the use of certain personal credits against the AMT. "The AMT relief prevents 24 million families from facing an average tax increase of at least \$2,000 each," said Sen. Chuck Grassley, an Iowa Republican.

This temporary solution, or "patch," merely postpones the fundamental AMT problem into next year. The AMT, whose origins date back to the late 1960s, is an alternative way of calculating your federal income tax. It was created in an effort to prevent a tiny group of high-income people from avoiding tax entirely. The rules for the AMT differ sharply from the regular system. For example, some popular deductions, such as those for state and local taxes, aren't allowed under the AMT. That's why some of the people most likely to be affected by the AMT are those who live in high-tax areas, such as New York City, New Jersey and California, and who make between \$100,000 and \$500,000.

If you're ensnared by the AMT this year but might not be next year, don't prepay state and local taxes this year that aren't due until early next year, says Greg Rosica, tax partner at Ernst & Young in Tampa, Fla. Consider deferring paying bills, such as investment-management fees, that won't be deductible this year but might be next year.

State and local taxes. The new legislation revives a provision allowing taxpayers who itemize to deduct their state and local sales taxes, instead of state and local income taxes. This provision has been especially popular in Florida, Texas, Washington and other states that have no state income tax. Congress extended this provision through the end of 2009.

You have a choice on how to calculate the deduction: You can claim the actual amount of sales tax you paid, assuming you kept good records. Or you can deduct the amount shown in tables issued by the Internal Revenue Service -- plus sales taxes you paid on certain items such as a car or boat.

If you itemize and live in a place with no state income tax, be sure not to miss this deduction. Studies have shown many eligible taxpayers overlook it. Even if your state has its own income tax, check to see if you would benefit from deducting sales taxes. As long as you itemize, you're eligible to deduct either sales taxes or state and local income taxes -- just not both.

Tuition and fees deduction. Congress extended through 2009 a provision allowing a special deduction for higher-education tuition and fees. The maximum

deduction is \$4,000, but not everyone is eligible. How much you can deduct, if anything, depends on your income. About four million federal income-tax returns filed for 2006 claimed the tuition-and-fees deduction.

You can claim this deduction whether or not you itemize. Such provisions are called "above the line" deductions since they appear on the federal income-tax return above the line for adjusted gross income.

Charitable giving. Congress extended a provision allowing taxpayers 70½ or older to transfer as much as \$100,000 a year directly from an IRA to charity without owing income taxes on the money. This transfer is counted toward the taxpayer's required minimum distribution for the year. "This allows people who have to take mandatory distributions from their IRAs an opportunity to avoid a tax hit while helping out a favorite cause," says Mark Luscombe, principal tax analyst at CCH, a Wolters Kluwer unit.

Some donors have been holding back on gifts from IRAs. It's now safe to go ahead for this year and again in 2009. Keep in mind that the amount you transfer isn't included in your adjusted gross income, or AGI. That's important since taxpayers lose some itemized deductions and personal-exemption amounts when their AGI exceeds certain levels.

Other changes include:

Lawmakers extended for three years a provision allowing taxpayers to exclude mortgage-debt forgiveness from taxable income. Usually, this type of debt forgiveness is considered income for tax purposes. Under the old law, this expired after 2009. The new law extends this protection through 2012, according to CCH.

Congress extended a provision allowing elementary- and secondary-school educators who pay for classroom supplies out of their own pockets to deduct as much as \$250 a year. This above-the-line deduction was extended through 2009.

IRS officials sounded pleased -- and relieved -- by congressional action. IRS Commissioner Doug Shulman said the passage of the AMT and other extensions is "a great outcome for the nation's taxpayers."

Write to Tom Herman at tom.herman@wsj.com

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